

Banxico – Dovish tone, but still bound to the Fed’s hike in December

October 29, 2015

- Banxico released today its monetary policy decision, in which the board decided to leave the reference rate unchanged at 3%, as it was widely expected
- According to Banxico statement, cyclical conditions of the Mexican economy continue show weakness, while inflation will remain below the 3% target in 2015
- We believe that the central bank remains “tied” to the Fed’s monetary policy decision in December, in which we expect Banxico to hike as well...
- ...however, the central bank’s more *dovish* stance relative to the Fed suggests that Banxico will adequate its monetary policy to Mexico’s business cycle, and will not necessarily follow the Fed in 2016
- The minutes of today’s meeting will be released on November 12, and the next monetary policy announcement will take place on December 17
- No significant changes in Mexican assets prices following Banxico’s decision today

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Monetary policy decision – More dovish than the Fed, but still bound to the Fed’s hike in December. Banxico just released its monetary policy decision, in which the board decided to leave the reference rate unchanged at 3%, as it was widely expected. In our opinion, Banxico sees no need to move the current monetary policy given that the balance of risks for both growth and inflation remained unchanged vs. previous meeting. However, Banxico highlighted again its concern with the uncertainty surrounding the Fed’s normalization of monetary policy, and its effect on the exchange rate given that: “...any actions from the U.S. Fed could have additional repercussions on the Mexican exchange rate, inflation expectations, and the overall price dynamics...”. We believe that the central bank remains “tied” to the Fed’s monetary policy decision in December; nevertheless, the central bank’s more dovish stance relative to the Fed suggests that Banxico will adequate its monetary policy to Mexico’s business cycle, and will not necessarily follow the Fed in 2016.

The slow recovery of the Mexican economy continues. In our opinion, the tone of Banxico’s *communiqué* regarding Mexico’s economic growth is more negative than in September’s statement. In particular, the central bank considers that the recent figures suggest that Mexico’s exports have decelerated given the slower growth dynamics of external demand, while investment continues to show a weak expansion. Moreover, the board considers that the slack in Mexico’s economy remains, which will not translate into demand-side pressures on prices; and, in addition, the board considered that the balance of risks for the Mexican economy has worsened in relation to September’s meeting.

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Relative monetary conditions and exchange rate remain the most important factors in Banxico's decision-making process. The monetary authority concludes that cyclical conditions of the Mexican economy continued to show weakness while inflation will remain below the target in 2015. However, as it was also mentioned in September's *communiqué*, the board members warned again that: "...any actions from the U.S. Fed could have additional repercussions on the Mexican exchange rate, inflation expectations, and the overall price dynamics...". In this context, the board will pay particular attention to "... the pass-through of the exchange rate to inflation, the relative monetary conditions between Mexico and the United States, and the evolution of the slack in the economy...".

We maintain our view that the central bank's next move will be a hike, immediately after the Fed in December. While Banxico's central scenario seems to be of economic activity weakness and inflation below target until year-end, the prospects of higher rates in the United States pose a significant risk to exchange rate and inflation levels in Mexico. Given this, we believe that Banxico's next move will be a rate hike, immediately after the Fed starts its normalization of monetary policy in December 15-16. This implies that the central bank could be raising rates at its next regular meeting on December 17. However, the central bank's more dovish stance relative to the Fed suggests that Banxico will adequate its monetary policy to Mexico's business cycle, and will not necessarily follow the Fed in 2016

From our fixed income and FX strategy team

No significant changes in Mexican assets prices following Banxico's decision today Muted market reaction following Banxico's *communiqué*, as it depicted subtle changes from the previous decision back on September 21, holding their strategy of waiting signals from the Federal Reserve and acting in tandem with them in order to maintain rates spreads steady. The more notorious change came with a slightly dovish bias in the assessment for the economy. Investors are waiting for more important details to come next week (November 4th) when the central bank releases the Quarterly Inflation Report (accompanied by a presentation of Governor Carstens). Local rates continue portraying upward pressures since the Fed released its policy statement yesterday, albeit with a modest relief in the short-end post Banxico's statement taking into consideration the dovish bias coming from the current economic environment. Despite this short-lived market adjustment following the strong rally in the previous 4 weeks, we hold a positive view on the Mexican fixed-income market. The local yield curve draws an attractive slope, spread against U.S. Treasuries and forward rates that compares favorably with most of the curves observed in EM. In this regard, we acknowledge a better relative valuation in Mbonos Dec'19 to Dec'24. Moreover, Mexican linkers (Udibonos) from Jun'19 to Jun'22 also depict a good investment opportunity.

In the FX market, the peso traded marginally weaker after the report and is currently at 16.62 per dollar. A more dovish tone regarding growth could be behind this reaction but we advise not to read too much into it, believing that Banxico's core message was fundamentally unchanged. In particular and focusing on the exchange rate, we highlight that the Board remains cautious as they warned about the likelihood of higher volatility ahead (which could impact the currency despite recent gains) and of a policy adjustment if needed. All in all, we continue seeing muted support for the peso from a wider interest rate differential against the US in the short term as Banxico remains closely tied to actions from the Fed. Moreover, regional peers such as Colombia, Peru and Chile have started hiking rates, which could strip the peso of some of its attractiveness at least on the margin. Given recent developments both in the US and the rest of the world, we reiterate our recommendation to buy dollars below USD/MXN 16.50, with investors likely defensive at least until the Fed's December meeting and with no local catalysts in sight that could counter for the potential of renewed appetite of dollars after yesterday's FOMC meeting.

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